

FACT SHEET:
H.R. 3840 The Narrowing Exceptions for Withholding Taxes (NEWT) Act

BILL SUMMARY:

The Narrowing Exceptions for Withholding Taxes (NEWT) Act would expand the income categories that are subject to Medicare payroll taxes so employee-shareholders of S corporations could no longer avoid paying this tax by reporting artificially low wage income and correspondingly higher dividends or profits. Certain employee-shareholders of S corporations would have to calculate their Medicare payroll tax obligation based on their share of the S corporation's profits or dividends, not just income reported as wages. The individuals subject to the provision are the employee-shareholders of a professional service business where the principal assets of that business are the skills and reputations of three or fewer individuals.

The NEWT Act targets the S corporations that have been identified as the most likely to abuse the system. These are professional service businesses engaged in the fields of health, lobbying, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, brokerage services, or investment advice or management.

EXPLANATION OF CURRENT LAW:

Medicare payroll taxes are imposed at a rate of 2.9 percent on all wage income. Under present law, certain self-employed individuals try to avoid paying Medicare payroll taxes on a portion of their wage income by routing it through an S corporation. In general, S corporations do not pay income tax. Instead, the income gains and losses of an S corporation "flow through" to shareholders' individual tax returns. By law, S corporations can have no more than 100 owners; but they are typically far smaller, with GAO estimating that 94 percent of S corporations have 3 or fewer owners.

A shareholder of an S corporation who performs services as an employee is subject to Social Security and Medicare payroll taxes on his or her wage income, but generally is not subject to payroll taxes on amounts that are not wages (such as dividends and profits). Nevertheless, an S corporation employee-shareholder is subject to payroll taxes on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wage income. Where an employee-shareholder is entitled to a significant amount of S corporation income, there may be a temptation under present law to understate what portion of the income is compensation for services (and subject to payroll taxes) and correspondingly increase the amount treated as a dividend or profit.

SCOPE OF THE PROBLEM:

Underreporting of wage income is rampant among employee-shareholders of S corporations. The GAO estimates that in the 2003 and 2004 tax years, individuals who used

S corporations underreported more than \$23 billion in wage income. The median misreported amount was \$20,127.

There is no clearly enforceable rule today to help tamp down on this abuse in an efficient manner. If the IRS audits an individual who uses an S corporation, the auditor determines the appropriate reporting based on the facts and circumstances of the individual case. However, the IRS does not have the resources to investigate all four million S corporations.

The American Jobs and Closing Tax Loopholes Act of 2010 (HR 4213) passed the House of Representatives in December of 2009 and included a provision closing this S corporation loophole. At the time, the Joint Committee on Taxation (JCT) estimated that closing this loophole would raise \$11.2 billion over ten years.

EXAMPLES OF ABUSE:

Newt Gingrich released his 2010 tax returns and disclosed \$444,327 in wage income from Gingrich Holdings, Inc. and Gingrich Productions, yet he reported \$2.4 million of earnings from those corporations as profits or dividends. By classifying nearly all of his \$3 million in earnings as profits through S corporations, Gingrich avoided paying an estimated [\\$69,000 in Medicare payroll taxes](#).

John Edwards earned \$26.9 million from his work as a trial lawyer in 1995. He paid himself a salary of \$360,000 each year for four years and took the rest as profits and dividends through an S corporation. This saved Edwards [\\$591,112 in Medicare payroll taxes](#) over those four years.